Fed Watch

US

June 28, 2013
Economic Analysis

US

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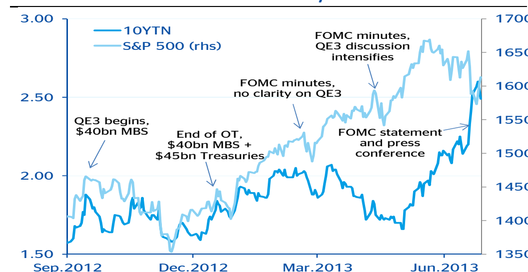
FOMC Members Speak to Calm Market Overreaction

- **Treasury bond yields and mortgage rates spike as equities drop following June 19th statement and press conference**
- **Fed policy in line with our expectations, though the definite path is dependent on the pace of the recovery and the inflation outlook**

The latest FOMC meeting announcement and the Chairman's press conference were intended to provide a clearer view on monetary policy, yet market reactions were quite dramatic and to a large extent, opposite to the Fed's intentions. Bernanke's press conference was meant to reinforce Fed's communication transparency with a bit more clarity on tapering and the eventual end to QE3. A key goal with their highly accommodative monetary policy stance has been to maintain downward pressure on long-term interest rates; however, Bernanke's assessment of slowing asset purchases by the end of 2013 sent markets into overdrive. Additional comments from the FOMC meeting statement also contributed to this unexpected market reaction, including views that the downside risks to the economy and labor outlook have diminished since start of QE3, an introduction of a new unemployment threshold of 7% for the end of QE3, and improved expectations for reaching the 6.5% unemployment rate threshold for the first policy rate hike in 2014 (vs. previously thought 2015). Overall, the result was that the 10-year Treasury yield jumped from 2.2% to 2.6% in less than one week, while mortgage rates spiked and equity markets tumbled to the lowest levels seen throughout the month, all of the above being out of character for a response to the Fed's continued stimulus.

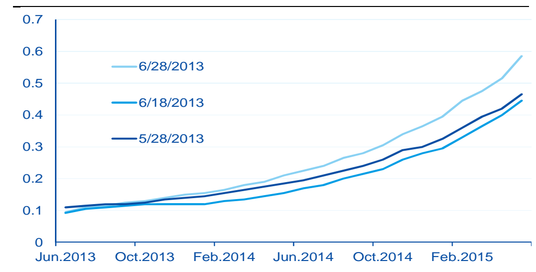
Since the announcement, many FOMC members have taken the stage to address this puzzling mismatch between the Fed's desired impact and actual market reactions. It is clear that Bernanke and his FOMC colleagues were thrown for a loop, with most of them deeming it an "overreaction", stressing that QE3 is still very data dependent and could continue at full speed if economic indicators disappoint. The main focus of the most recent Fedspeak has been to re-emphasize the difference between QE and the Fed Funds guidance as a way to anchor long-term yields to the latter, and thus promote an orderly and slow yield curve normalization process. This implies full understanding that scaling back QE3 still means continuation of monetary policy accommodation and balance sheet growth, which should not be confused with the tightening of monetary policy (increase of the Federal Funds rate) that is expected to come later in 2015-2016. While both QE3 and the near-zero Federal Funds rate are intended to support a stronger recovery, QE3 is more geared toward increasing activity and confidence in the short-term and is therefore tied to different criteria. Another takeaway from the latest Fedspeak has been lack of concern over low inflation and agreement that most downward price pressures are due to transitory effects.

Chart 1
S&P 500 and 10-Year Treasury Yield (%)



Source: WSJ, FRB, & BBVA Research

Chart 2
Federal Funds Rate Futures (%)



Source: Federal Reserve & BBVA Research

While the markets seemed to be somewhat surprised by the timeline for dialing down the current pace of asset purchases outlined by the Chairman, the details revealed remain consistent with our baseline scenario. We continue to expect that the FOMC will begin to dial down asset purchases in late 3Q13, ultimately concluding the program in 1H14, as long as economic activity continues to improve at a steady pace. Furthermore, we expect that the Fed will first increase the Fed Funds rate in 3Q15, prior to continuing its exit strategy with asset sales in 2Q16. However, the plan is not quite set in stone and there is plenty of room for the Fed to stray from this suggested timeline.

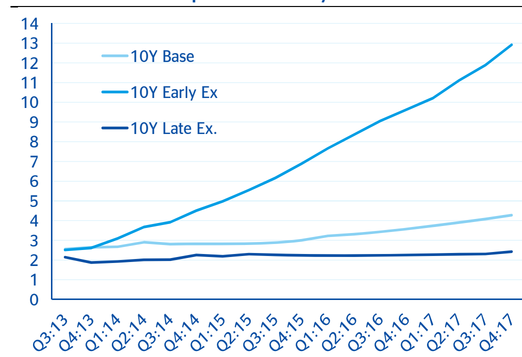
Two Alternative Future Paths of the 10-Year Treasury Yield

In light of the recent spike in the 10-year Treasury yield responding to the possible, yet misunderstood, early increase of the Federal Funds rate, we present two scenarios of how the current path of monetary policy can differ due to unexpected changes in the economic environment.

Early Exit Forced by High Inflation: Inflationary concerns have moved to the back burner as of late, yet the few FOMC hawks are still adamant about the costs to QE3. In the off chance that inflationary pressures spike rather quickly, we could see a sooner start to dialing down asset purchases, potentially ending QE3 by December 2013. With the pickup in economic growth implied by this scenario, we expect that the Fed could shift up the first target rate hike to 2Q14 and then start asset sales in late 4Q14. Given muted price pressures, we believe that this scenario has a low probability.

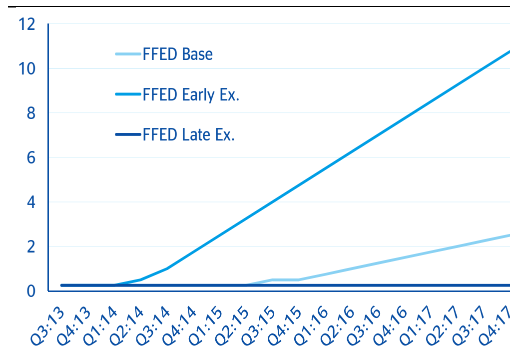
Late Exit Weighed by Slow Growth: The unexpected downward revision to 1Q13 real GDP growth could spark worries of a slower-than-expected recovery. If this unimpressive pace of growth continues and inflationary pressures remained subdued, we could potentially see a delayed response from the Fed with regard to both QE3 and the first target rate hike. In this case, we expect that asset purchases could continue at the current pace of $85bn per month through 2014, tapering slowly in 2015 and 2016, with an ultimate end to QE3 in 4Q16. This scenario would also suggest no increase in the Fed Funds rate at least through 2017. Likewise, we don't assign a high probability to this alternative scenario.

Chart 3
10-Year Zero-Coupon Treasury Yield (%)



Source: BBVA Research

Chart 4
Federal Funds Rate (%)



Source: BBVA Research

Bottom Line: Fedspeak Hopes to Calm Market Overreaction

It has become clearer in the past few days that market reactions to the FOMC statement and Chairman press conference were not quite what the Fed had expected. The ongoing response in the Treasury bond market has made it clear that the Fed's policy is not set in stone and will remain highly responsive to unexpected changes in economic activity. We maintain our baseline expectations for dialing back QE3 beginning in late 3Q13, while we expect the Fed's policy will remain data-driven and strongly contingent upon clear communication and transparency. Given this "overreaction," we expect that markets could correct somewhat in the coming weeks. With very few economic reports due out before the next FOMC meeting, there is little to suggest any significant shift in Fedspeak or a change in July's FOMC meeting statement. Also, we do not expect that the minutes from this past meeting will warrant a sharp increase in long-term interest rates.

Table 1
Federal Reserve Commentary, Post FOMC Statement and Press Conference

	Jerome Powell Governor June 27, 2013	William Dudley FRB New York June 27, 2013	Jeremy Stein Governor June 28, 2013	John C. Williams FRB San Francisco June 28, 2013	Jeffrey Lacker FRB Richmong June 28, 2013
Growth	There are, in my view, good reasons to believe that the economy will continue to gain strength.	I see persuasive evidence of **improved underlying fundamentals** for much of the private sector of the U.S. economy	With respect to the economic fundamentals, both the current state of the labor market, as well as the outlook, have **improved since September 2012**.	Economic growth is likely to be sluggish in the current and next quarter. It should pick up later in the year. For 2013 as a whole, I see inflation-adjusted GDP growing about 2¼ percent and picking up to around 3¼ percent in 2014.	Low growth in real gross domestic product, which has averaged 2 percent since the end of 2009, is likely to continue beyond 2013.
Inflation	There is some reason to think that the **recent low readings partly reflect transitory factors**.	A decomposition of the slowing in core inflation reveals that some of it is due to **slowing in the rate of increase in prices of non-food and non-energy goods**. This probably is due in large part to the softening of global demand for goods and the modest appreciation of the dollar that has occurred since mid-2011.	If, for example, inflation readings continue to be on the soft side, we will have greater scope for keeping the funds rate at its effective lower bound even beyond the point when unemployment drops below 6.5 percent.	Inflation will probably remain relatively low for a while, but should gradually rise toward our 2 percent target over the next few years. I expect our preferred inflation measure will gradually climb from less than 1½ percent in the second half of 2013 to roughly 1¾ percent in 2015.	Inflation is likely to edge back toward the FOMC's 2 percent target by next year.
QE3	If the Committee's economic outlook is broadly realized, and we do see the first moderation in the pace of purchases later this year, that would be good news.	... even if this scenario were to occur and the pace of purchases were reduced, it would still be the case that as long as the FOMC continues its asset purchases it is **adding monetary policy accommodation, not tightening monetary policy**.	Even if a data release from early September does not exert a strong influence on the decision to make an adjustment at the September meeting, that release will remain relevant for future decisions. If the news is bad, and it is confirmed by further bad news in October and November...the **remainder of the program would be extended accordingly**.	...future adjustments to our asset purchases in no way alter or undermine our approach of maintaining the current very low federal funds rate at least as long as the unemployment rate is above 6½ percent and the other conditions regarding inflation and inflation expectations are met.	The **benefit-cost trade-off associated with further monetary stimulus does not look promising**. The Fed seems unable to improve real growth, despite historic levels of stimulus, perhaps due to a decline in productivity growth and other factors outside the control of monetary policy.
Long-term Rates	Market adjustments since May have been **larger than would be justified** by any reasonable reassessment of the path of policy.	... market participants now expect the first increases in the federal funds rate target to come much earlier than previously thought. Setting aside whether this is the correct interpretation of recent price moves, let me emphasize that **such an expectation would be quite out of sync with both FOMC statements and the expectations of most FOMC participants**.	... consumers and businesses who look to asset prices for clues about the future stance of monetary policy should **take care not to over-interpret these movements**.	The time will come when we will no longer need to keep adding monetary stimulus. When that time comes, I am confident that **we can make this change without jeopardizing the recovery,** while working toward our goals of maximum employment and price stability.	The subsequent declines in the bond and stock markets in response are a normal part of the process of incorporating new information into asset prices and should not interfere with the likely scenario of moderate growth in real GDP. **Further asset price volatility is likely** as market participants gain additional insight from the Fed's policy actions and communications.

Source: Federal Reserve & BBVA Research

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